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SUBJECT: IMF NEAR AGREEMENT WITH GOT ON SEVENTH REVIEW

REF: ANKARA 1161

1. (Sbu) Summary: According to IMF Resident Representative Odd Per Brekk, the Fund Mission is near agreement with the GOT on a Letter of Intent for the Seventh Review. On the fiscal side, the GOT and Fund have agreed on measures to plug the 7 Quadrillion TL fiscal gap: increasing the cut in discretionary spending from 10 to 13 percent, reallocating 0.5 Quadrillion TL from earmarked Special Revenues to the general budget, cutting investment incentives and increasing natural gas, alcohol, and tobacco prices. The GOT-proposed cut in VAT rates on textiles is off the table, though the Fund has accepted a VAT rate cut on pharmaceuticals. Fund Staff is likely to consider the enactment of all these measures to be prior actions required before the board vote. On banking sector issues, the Fund has reached agreement with the head of the Bank Regulatory Agency and Economy Minister Babacan to increase legal protections for bank regulatory staff, narrow the ability of the higher court to overturn lower court banking-related rulings, and strengthen on-site inspection. Babacan has also reportedly agreed to help lower public expectations about potential Deposit Guarantee Fund collections. Brekk said the World Bank continues to work with the GOT on developing a new strategy for the State Banks. The IMF is likely to wrap up discussions next week, with a board vote in April. End Summary.

IMF and GOT Close Fiscal Gap:

2. (Sbu) IMF Resident Representative Odd Per Brekk told us today that the Mission and the GOT had reached broad agreement on the measures needed to close the 7 Quadrillion (\$5.2 billion) 2004 fiscal gap. According to Brekk, about two-thirds of the adjustment would come from the spending side. By increasing the previously-announced 10 percent across-the-board cut in discretionary spending to 13 percent the Fund estimates this cut will save 3.8 Quadrillion TL. The Parliament's Budget Committee approved the increased cut last night, and Brekk said the full Parliament was supposed to vote on the amendment today.

3. (Sbu) Another 0.5 Quadrillion TL will be gained by reallocating funds from Special Revenues to the General Budget, i.e. by cutting the spending for which these off-budget funds were allocated. There would also be (unspecified) reductions in investment incentives. The remainder of the fiscal gap will be filled through a combination of increased taxes on alcohol, tobacco and natural gas (contrary to the public statements by the Energy Minister). The Mission has agreed to let the GOT have another week to try to convince Turkey's Iranian gas supplier to lower prices, but if this fails the GOT has agreed to raise local gas prices instead.

4. (Sbu) Brekk also confirmed that the GOT proposal to reduce the Value-Added tax rate on the textile sector from 18 to 8 percent was no longer under discussion--in fact, he said it was a condition of the IMF Mission even coming to Turkey that the GOT stop pushing this idea. The proposed decrease in VAT rates on pharmaceuticals, however, had been accepted by the Mission, which believes it will be revenue neutral. Note: In a separate meeting, the leading opposition parliamentarian on the budget committee, who is also a former director of the tax administration, told econoff this measure would entail a net loss to the State. End Note.

5. (Sbu) Brekk said the IMF has yet to take a formal decision but he believes all of the above revenue and tax measures will become prior actions.

## Banking Sector Issues:

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16. (Sbu) The Mission has reached agreement at the level of Bank Regulatory Agency (BRSA) Chairman Tevfik Bilgin, reportedly with Economy Minister Babacan's support, on three politically-sensitive revisions to the banking law. First, Bilgin and Babacan agreed to incorporate increased legal protections for staff at the BRSA and the Deposit Guarantee Fund (SDIF). Note: IMF staff have long been pushing for these protections, and these agencies risk paralysis if official acts are constantly questioned and investigated, as now seems to be happening. End Note. Second, the high court of appeals--which has been revisiting the substance of the decisions made by the lower court specialized in banking issues--would be allowed to review only the process by which the lower court decision was taken. Third, the BRSA's on-site inspection powers would be strengthened. The BRSA would be authorized to bring in outside expertise, besides the sworn auditors who have monopolized bank inspection. Bilgin, himself a former sworn auditor, is reportedly unhappy with this measure.

17. (Sbu) Brekk said Babacan has also agreed to help try to lower public expectations about the sums likely to be collected by SDIF from failed bank owners or from assets currently held by the SDIF. Several current and former bank regulators have complained to econoffs about this problem, and Brekk said Babacan agreed to a press conference at which the public would be informed about the GOT's more realistic expectations.

18. (Sbu) Brekk noted the ongoing work of the World Bank team that has been in Turkey studying the issue of the state-owned banks. Though there is no concrete plan as yet, according to Brekk, one idea the Bank is looking into is to remove the large government securities portfolios from the state banks, and try to create a "real bank" from what's left and run it professionally. Econcouns noted with concern that the GOT seems to have completely reversed course on state bank privatization (see septel).

19. (Sbu) Brekk said the GOT and bank regulators have decided to merge SDIF-intervened Pamuk Bank with state-owned Halk Bank, a far better approach in the Fund's view than a possible cession of Pamuk Bank to Demir Bank's former owner. The latter idea had been briefly under consideration as a way to get Demir Bank's owner to drop his lawsuits against SDIF and HSBC, which bought Demir Bank from SDIF. Note: Current and former BRSA officials have told econoffs that the Pamuk-Halk merger makes sense because: a) it reduces the cost to the GOT of recapitalizing Pamuk and, b) it will help Halk improve both the quality of its staff and its systems. End Note.

110. (Sbu) Brekk said the consideration of SDIF's appeal of the Danistay's (State Court of Accounts) initial decision to overturn SDIF's takeover of Demir Bank is still pending. (Brekk revealed that IMF Managing Director Koehler had raised this issue with Prime Minister Erdogan, and wondered whether the court's delay stems from pressure from Erdogan.) Separately, HSBC CEO Piraye Antika told EconCouns that Demir's former owner has also filed a suit against HSBC itself, and that HSBC global management is quite concerned.

111. (Sbu) Brekk said the controversial Cukurova group continues to push for regulatory approval to allow the Cayman Islands-based "North Way" Production Company to repay Cukurova's debts to Yapi Kredi Bank and take over management of that bank. According to Brekk, BRSA Chairman Bilgin has been good so far about not accepting Cukurova's proposal. Brekk said the IMF continues to press the GOT to name a widely-respected person to lead an inquiry into the Icar Bank collapse but the GOT has not been able to identify a suitable candidate.

## Next Steps:

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112. (Sbu) Brekk was optimistic the Fund Mission would leave more or less on schedule next week. He doubted there would be a board vote before April, however, given the necessary preparation time and prior actions. Brekk said the Fund might reduce the planned number of reviews this year from five to three for practical reasons.

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